The New York Certified Public Accountant

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Wentworth F. Gantt

Managing Editor

The NEW YORK CERTIFIED PUBLIC ACCOUNTANT *is published monthly from October to June. Copies may be obtained at the office of the Society at twenty-five cents per copy, $2.00 per year. All other communications relating to this publication should be addressed to the Committee on Publications.*

STATE SOCIETY ACTIVITIES

SPECIAL NOTICE

THE EHRLICH BILL

On March 13, 1941, members of the Society were sent a communication with respect to the Ehrlich Bill which had been introduced in the New York State Assembly. The Committee on Legislation advises that the bill was referred by the Assembly Codes Committee to the Committee on Rules, where no further action was taken.

This bill, which provided that only lawyers could practice and appear for others before any administrative or other quasi-judicial body of the state, was vigorously opposed at Albany by this Society together with representatives of many other business and professional groups in New York State.

The opposition presented by the Society, which was continuous from March 3rd to April 3rd, was carried on by the officers and directors, the office organization (Mr. Gantt being in Albany for fifteen days), and chairmen and vice chairmen of two committees, and involved the preparation of several briefs and statements, numerous contacts with legislators, chambers of commerce, boards of trade, and the like, as well as preparation for active participation by the Society members had the bill been reported out of the Committee on Rules.

Calendar of Events

April 2—8 P.M.—Special Technical Meeting—Subject: Public Utilities Accounting—Location: Engineering Auditorium, 29 W. 39th Street, New York City.

April 9—Regular Meeting of the Board of Directors.

April 9—8 P.M.—Special Technical Meeting—Subject: Fiduciary Accounting—Location: Engineering Auditorium, 29 W. 39th Street, New York City.

April 14—7:45 P.M.—Society Meeting — Subject: Whose Balance Sheet Is It? Location: Waldorf-Astoria Hotel, Lexington Avenue and 49th Street, New York City.

April 16—8 P.M.—Special Technical Meeting — Subject: Automobile Dealers' Accounting — Location: Engineering Auditorium, 29 W. 39th Street, New York City.

April 23—8 P.M.—Special Technical Meeting — Subject: Investment Trusts — Location: Engineering Auditorium, 29 W. 39th Street, New York City.

April 30—8 P.M.—Special Technical Meeting—Subject: Consolidations and Reorganizations — Engineering Auditorium, 29 W. 39th Street, New York City.

May 7—8 P.M.—Special Technical Meeting — Subject: Restaurant Accounting — Engineering Auditorium, 29 W. 39th Street, New York City.

May 12—Regular Meeting of the Board of Directors.

May 12—7:45 P.M.—Society Meeting—Subject: To be announced

later. Location: Waldorf-Astoria Hotel, Lexington Avenue and 49th Street, New York City.

Radio Programs

As previously announced in these columns, the Society has presented a series of two broadcasts over Station WOR on the subject of Federal Income Tax Returns. These took place on the evenings of March 4th and 11th from 5:00 to 5:15 P.M., and at the close of the program it was stated that copies of the text would be available upon request at the office of the Society. Approximately 200 such requests have been received, together with some interesting comments on the two broadcasts. It is estimated that the programs reached a probable audience of 250,000 in New York City and vicinity, while some letters were also received from listeners in Connecticut, New Jersey, and Pennsylvania. Below are included a number of the comments made:

"I would appreciate your sending me a copy of the talk given over Station WOR with reference to income tax returns. In commenting, I wish to state that this broadcast was clear, concise, and indeed understandable."

"Thank you for your courtesy (in forwarding this script); I believe these interesting programs are invaluable."

"This afternoon between 5 and 5:15 P.M. I had the distinct pleasure of listening to your President, Mr. A. S. Fedde, over Station WOR, at which time he gave a very splendid talk on the preparation of income tax reports. I wonder if I would be requesting too much to ask that my name be kept on file to receive copies of any other talks given on this subject, either by Mr. Fedde or other members of your Society."

"I have listened to your talk on making out the income tax and found it very instructive. Will you kindly send me a copy of this talk, as I think it may be helpful to my daughter, who will be a first-payer this year."

"Kindly send me a copy of your very interesting broacast which was most helpful to all members of our class in economics."

In connection with the filing of New York State tax returns, the Society also secured time over the facilities of Station WMCA for the presentation of a similar broadcast as an aid to taxpayers in New York State. This program was given at 8:15 to 8:30 P.M. on Thursday, April 10th, and took the form of an interview between Mr. A. S. Fedde, President of the Society, and Mr. Stanford Bissell, Vice President of the Young Men's Board of Trade of New York City.

Special Technical Meetings

On the evening of April 2nd the Society's Committee on Public Utilities Accounting sponsored a very successful meeting at the Engineering Auditorium. Over 700 members and guests, including a large representation from the public utility industry, heard an excellent series of addresses on current topics in public utility regulation and accounting. The speakers included George Oliver May, member of the Society and vice chairman of the American Institute of Accountant's Committee on Accounting Procedure, Milo R. Maltbie, Chairman of the Public Service Commission of the State of New York, Dr. B. S. Rodey, Jr., Controller of the Consolidated Edison Company of New York, Inc.,

Dr. H. B. Dorau, Professor of Economics of New York University, and George Goldthwaite, of Hine, Goldthwaite & Mylott.

A great deal of credit is due Mr. Charles H. Dyson, Chairman, and to the members of the Public Utilities Accounting Committee for arranging such an interesting and instructive meeting. Many requests have already been received for copies of the papers delivered, and it is expected that the entire proceedings will be published in the May issue of THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT.

The dates of the remaining meetings in the Society's series of special technical meetings are as follows:

April 9 — Fiduciary Accounting — Archie F. Reeve, Chairman.

April 16—Automobile Dealers' Accounting—Alfred Wm. Oldehoff, Chairman.

April 23—Investment Trusts, George E. Niven, Chairman.

April 30—Consolidations and Reorganizations—Carol F. Hall, Chairman.

May 7 — Restaurant Accounting — William K. Borow, Chairman.

Reservation cards and programs for these meetings will be sent to the members, and those wishing to attend these meetings should notify the Society's office. Each member of the Society is allowed to invite one non-certified member of his staff to attend the special technical meetings as his guest.

Spring Conference

The Eighth Annual Chapter Conference of the Society will be held this year at Higby's, Big Moose, New York, on June 27-28-29, 1941. The program, which will consist of technical discussions and various entertainment features, will start Friday morning with informal sports. On Saturday competition will begin for the Hurdman and Hughes golf trophies and the Troper tennis trophy. Informal entertainment will be available at all times, and members are urged to start making their plans now for participating in this conference. Information will shortly be sent you pertaining to these activities, and your reservations should be made early at the Society's office.

Eighth Annual Outing

As the date approaches for the forthcoming Annual Outing and Tournament of the Society, we wish to remind the members that this will be held Tuesday, June 3, 1941, at the Westchester Country Club, Rye, N. Y. It is hoped that a large number will turn out this year, as the program will be a particularly good one.

The tennis tournament and informal golf will be held in the morning, following which luncheon will be served. The golf tournament will start after lunch and the finals of the tennis tournament will be decided in the afternoon. Dinner will be served at 7:30 P.M., at which time the prizes will be awarded.

As many members as can come are urged to attend this year and bring their friends with them.

Military Service

At a meeting of the Board of Directors on September 9, 1940, the following resolution was passed with respect to the remission of dues of any member of this Society entering the armed forces of the Nation:

"Resolved that the Society remit the dues for the period of active service of any member who enters the armed forces of the Nation by voluntary enlistment,

federalization of the national guard or conscription."

It is requested that members so enlisted or conscripted kindly communicate directly with the office of the Society in order that a record may be made of the date of their induction, and the branch of service which each member will enter, such as Army, Navy, Air Corps, Marine Corps, etc.

Committee on Nominations

The following is the personnel of the 1941 Committee on Nominations:

William H. Bell
Walter N. Dean
Myron A. Finke
James F. Hughes
Maurice E. Peloubet
Arthur H. Rosenkampff
Ira A. Schur
J. S. Seidman
Victor H. Stempf

Messrs. Seidman and Stempf were selected by the Board of Directors at its meeting on March 17th, and the other members were selected at a regular meeting of the Society on March 17th.

April Society Meeting

On the evening of April 14, 1941, at the Waldorf-Astoria Hotel, members of the Society had the pleasure of hearing an address by Mr. Victor H. Stempf, director and past president of the Society, on the subject of "Whose Balance Sheet Is It"? Interesting comments on his paper were made by Messrs. Charles B. Couchman and Saul Levy, members of the Society. The text of Mr. Stempf's address will be published in the May issue of THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT.

"Financial Statements—What They Mean"

A pamphlet by the above title will shortly be received by members of the Society. It attempts to improve the understanding of financial statements by conveying a general impression of the nature and purpose of balance sheets and income statements, but without going into a detailed explanation of underlying accounting theories. Prepared by the American Institute of Accountants, it is being distributed widely through the various state societies. Members of this Society will be requested to distribute as many copies as they can to their various clients, friends and business acquaintances.

Erratum

The Society has been notified that the names of Mr. William C. Pieper, 97 Chatsworth Drive, Toronto, Canada, and Lewis I. Septimus, 926 Lafayette Avenue, Brooklyn, N. Y., were omitted from the official list of individuals who passed the October, 1940, examinations.

Inasmuch as their names were not included in the list published in the March issue of the Bulletin, this announcement will serve the purpose of calling the omission to the attention of our membership.

PROFESSIONAL COMMENT

Auditors' Liability

A case has recently been decided by a Federal District Court in Michigan (Maryland Casualty Co. vs. Cook et al, 35 Fed. Sup. 160), concerning the liability of a certified public accountant. Mr. E. J. Buehler, Chairman of the Society's Committee on Auditors' Liability, has prepared the following commentary on this case:

The City of Flint, Michigan, prepared specifications for audit for the year ended June 30, 1932, which were submitted to any certified public accountant who cared to make a bid for such audit. The specifications provided in part that the bids should be for a complete audit of the transactions of the various boards, departments and offices on a monthly basis. They also provided that the cash balances were to be verified at the beginning of the fiscal year, that a cash count was to be made each month, that all cash receipts were to be verified by deposits in the City's depositories, and that disbursements and purchase orders were to be verified as to legality, etc. The specifications further provided that "any other duties or procedures which ordinarily become a part of a complete audit, although not specifically stated herein, shall be deemed a part of these considerations". There were other requirements not mentioned here, including one to the effect that no payment would be made by the City before the completion and acceptance of the work for the fiscal year, unless a surety bond for faithful performance of the contract was filed.

Jonathan Cook submitted a bid in accordance with these specifications. Subsequently a contract was entered into between the accountant and the City of Flint for an audit for the year ended June 30, 1932. The Commercial Casualty Insurance Co. executed a bond on behalf of the accountant.

It appears from the decision of the Court that Conklin, the City Treasurer, embezzled monies for several years in various ways, principally in connection with delinquent personal property taxes owing to the City. For example, he collected delinquent taxes voluntarily paid by the taxpayer, issued what has been termed a temporary receipt, and then made no record of the tax payment in his office. In another instance, he issued the official City receipt but the duplicate copies of such receipt that were supposed to be recorded in his office were destroyed, and no record of the taxpayer having paid such item was made. In other instances, he altered the delinquent tax roll by increasing the amount shown thereby to be owing in an amount sufficient so that his books balanced despite his embezzlement of the tax money which he had collected.

The Treasurer had been bonded by the Maryland Casualty Company and the United States Fidelity and Guaranty Company, which companies, as a result of these embezzlements and misappropriations, paid some $16,000.00 to the City. These companies thereupon were subrogated *pro tanto* to the City's right of action against the accountant for his negligence in auditing the books of the City, in consequent of which negligence the earlier defalcations of the Treasurer were not discovered and he was left in a position to commit subsequent defalcations.

The Court quoted at length from the specifications for the audit and the contract for the audit. The contract made the specifications a part of the audit contract and required that the audit engagement be performed in accordance with the specifications.

What, said the Court, is the meaning to be given to the contract and specifications? Are they to be interpreted by the usual literal meaning of the words, or are they to be interpreted as requested by the defendant on the basis of accounting terms? These technical accounting terms have been referred to as a cash audit, as a balance sheet audit, and as a detailed audit. Some of the accountants testifying said that this contract and specifications required a cash audit. Some said it required a balance sheet audit. Some said it required a combination of a cash and balance sheet audit, and some others said that it required a detailed audit.

The Director of Finance for the City of Flint in drawing these specifications and drawing this contract had no knowledge of technical auditing terms. Neither did the City Commission, which had the authority to make the contract with such specifications, have any such knowledge. They did not know what a cash audit

meant or what a detailed audit meant or what a balance sheet audit meant. They did not have these technical terms in mind. They knew they wanted a complete audit. They knew some things that they wanted done for the City by the accountants, so they put those things down first. Then after they had mentioned the specific details that they knew they wanted covered, they went on and used general language to include everything else that was ordinarily required to be done in the making of a complete audit.

Accordingly, the Court determined that the contract and specifications should be interpreted according to their literal and usual meaning. There was nothing to indicate that a partial or limited audit was intended. The language called for a complete audit. There was nothing to guide the Court in an effort to classify it as a cash audit, a balance sheet audit, or a detailed audit. If the Court so classified this audit contract, it would necessarily then have to reach a conclusion as to exactly what work that classification called for. The net result of such reasoning, the Court said, would lead to an interpretation contrary to the plain, ordinary, everyday meaning which this contract and these specifications disclose for themselves.

Therefore, the Court concluded that the audit engagement was not limited and that it should be interpreted according to its literal meaning, its actual meaning, its plain everyday, common-sense meaning.

The Court also stated that accountants should realize that if they want a particular contract which they enter into to be measured in the technical terms of a cash audit, or a balance sheet audit, or a detailed audit, they should insist that their contract (and the specifications which they agree to comply with in their contract) state the facts plainly.

The witnesses all agreed that no technical terms or language was used in either the contract or the specifications. Ordinary, everyday English was used. It is easily understood and interpreted. If accountants, continued the Court, wish a contract construed in accordance with their own technical language, then they must see to it that their technical language is used in their contracts.

The accountant testified that on reading the specifications he did not know just what work was required to be performed, and so he had a talk with the Director of Finance and thereafter entered into the contract in reliance upon that conversation had prior to the execution of the contract. The Court stated that that conversation did not mean a thing; that it was the contract which the accountant made with the City which was to be construed—and not conversations or oral agreements reached with independent officers of the City. Those prior conversations, in order to become binding, should have been embodied in the written contract which was signed pursuant to proper authority. Therefore, the Court had no alternative but to hold the defendant to performance in accordance with the terms of his written contract.

While the Court interpreted the contract for the audit to require a complete audit within the broad aspects of the meaning of that word, it reached the conclusion that it did not make any difference in deciding as to negligence or non-negligence whether it was interpreted as a complete audit within the broad aspects of the contract or as a combination cash and balance sheet audit. This was so because all the certified public accountants who testified agreed that reasonable care should have been used in test checking, or in some other way, to see that the figures in the controls were in balance with the detailed ledgers. There was not a reasonably careful audit performed by the defendant auditor on either basis, whether it be on the basis of the complete audit or on the basis of the combination cash and balance sheet audit.

The Court reached the above conclusion for various reasons:

1. **Lack of confirmations from debtors:** The auditor made no attempt to circularize the delinquent accounts outstanding. If this had been done, the probabilities are that the discrepancies would have been discovered. The Court stated that the delinquent accounts should have been canvassed and selected persons contacted, either by personal call, by telephone or by a form letter.

2. **Alterations of the tax rolls:** There were many alterations of the tax rolls, some of them being very crude. Those alterations could have been discovered by the auditor if the tax rolls had been totaled and then compared with the rolls of the Assessor's Office which were not altered, and the discrepancies would immediately have come to light. The auditor paid no attention to the original assessor's rolls which were a part of the City's books and records and hence were required to be audited and examined.

3. **Lack of audit of delinquent tax rolls:** It was incumbent on the auditor to audit various delinquent tax rolls, including the current roll. He should have determined whether or not the delinquent balances outstanding on each and every one of these tax rolls balanced with the controls. The Court believed and found that this was not done.

4. **Lack of harmony with controls:** The auditor found that the total of the delinquent balances outstanding as shown by the tax rolls over a period of years was not in balance with the total shown by the controls for the same period. He stated that the only thing he did was to mention it orally to the Director of Finance but he then proceeded in the annual report to certify to a stated figure for delinquent taxes, when actually it was not the true amount and he had no knowledge as to what was the delinquent balance outstanding. The auditor did not balance these records or require the City to do so.

5. **Lack of proof of additions:** When the auditor ran adding-machine tapes, he used figures superimposed on the tax roll in lead pencil. The Court pointed out that machines of the City Treasurer's office staff, for their convenience, had placed at the edge of the page in lead pencil what they claimed represented the delinquent balances outstanding, and that when the auditor ran his adding-machine tapes he used those pencil figures without checking them with the figures in ink to determine whether or not the pencil figures were accurate. Many of them were not accurate and a careful check would have so disclosed.

6. **Lack of comparisons with related records:** The auditor failed to audit the control as maintained in the City Treasurer's office either with the control in the office of the Director of Finance or with the tax rolls themselves. Had he audited such book in comparison with either the controls or the rolls he would have found the records decidedly out of balance.

It was the failure to do those things that forced the Court to the conclusion that the auditor failed to perform faithfully his audit engagement. With a reasonable degree of care the many defalcations would have been discovered. The failure on the part of the auditor to do those things made it clear to the court that he did not make the audit he had contracted to make and he did not do what a reasonably prudent auditor would and should have done in the circumstances. He was negligent.

For the failure to perform this audit engagement in accordance with the terms of the contract as a reasonably prudent and careful auditor would, and because of such negligence, the defendant auditor must respond in damages.

Was the negligence of the defendant auditor, queried the Court, the proximate cause of the damage for which this suit against him is brought?

One of the purposes of the audit was to determine whether or not any of the employees of the City were defrauding the City of its money. If these irregularities, which were apparent from the books, had been brought to the attention of the City by the auditor, the Treasurer's services would have been terminated and the City would not have been put to the further loss suffered by it by reason of the subsequent misappropriations and peculations by the City Treasurer.

The Court held that the auditor was obligated to respond in damages for the amount of the shortages accruing after the negligent performance of the audit engagement.

It will be recalled that the audit specifications and contract provided that no payments would be made by the City before the completion and acceptance of the work for the fiscal year unless a surety bond for the faithful performance of the contract was filed. Without here discussing this phase of the case in detail, it might be pointed out that faithful performance of the audit engagement was required; that the Court stated that the auditor did not faithfully perform his audit engagement; and therefore that the Commercial Casualty Insurance Co. was obligated on its bond to the Maryland and the United States Companies, apparently in the amount of the audit fee.

Wages and Hours for Accountants

As the result of a number of inquiries received from accountants regarding the status of their employees under the fair-labor-standards act of 1938, the Wage and Hour Division of the U. S. Department of Labor has requested that the following letter be called to the attention of members of the accounting profession. The letter was dated February 17, 1940, and was signed by George H. Kennedy, Jr., Supervisor, Trade and Labor Relations, Wage and Hour Division, U. S. Department of Labor, Washington, D. C.

> "This will acknowledge receipt of your letter of ...., 194.., in which you inquire about the applicability of the fair-labor-standards act of 1938 to the employees of accounting firms.
>
> "The act, a copy of which is enclosed, applies to employees en-

gaged in interstate commerce or in the production of goods for interstate commerce. Whether an employee is so engaged depends, of course, upon the facts in the particular case. For your information I am enclosing copies of interpretative bulletins Nos. 1 and 5, which discuss the general coverage of the act. Your attention is particularly directed to paragraphs 2 through 4, 8, and 9 of bulletin No. 5.

"Employees of accountants who are engaged in preparing stockholders' reports, balance-sheets, or other financial statements and documents which are sent out of the state directly by their employer or indirectly by his clients would seem to fall within the general coverage of the act. The same is true with regard to those employees engaged in activities incidental to the preparation of such materials. In this connection, see paragraph 5 of bulletin No. 1.

"Your attention is called to section 13(a) (1) of the act which provides an exemption for any employee engaged in a bona fide 'professional' capacity. Enclosed is a copy of regulations, part 541, and you will note that section 541.3 thereof defines and delimits the scope of the above-quoted portion of the act. Any employee who satisfies these exemptions is exempt from both the wage and hour provisions of the act.

"There are, of course, many stages of professional expertness among accountants. It is clear that an ordinary bookkeeper who performs simple calculations is not a professional worker. We have also expressed the opinion that certified public accountants rendering professional services may generally qualify under the exemption afforded by section 541.3 of regulations, part 541, provided they receive a salary or fees of at least $200 per month. It has been our policy in answering such inquiries simply to indicate that the exemption would apply to persons performing accounting services if they met all the criteria set forth in section 541.3 of the enclosed regulations.

"All employers whose employees are entitled to the benefits of the act are required to keep records; however, no particular form is prescribed. In this connection, see section 516.2 of the enclosed copy of regulations, part 516.

"I am enclosing for your information a copy of interpretative bulletin No. 13 and
{a workers' }
{an employers'} digest. If you have any further questions I shall be glad to offer all possible assistance."

Expenses Incurred by Investors

On March 10, 1941, the Society's Committee on Federal Taxation addressed a communication to the Commissioner of Internal Revenue in Washington, D. C., requesting certain information with respect to deductions of expenses directly related to the production of taxable income. In the Higgins decision of February 3, 1941, the United States Supreme Court held that expenses of this nature were not deductible to an investor. In stating its objection to this legislation, the Committee also inquired as to whether the Higgins decision would be made effective retroactively by the Bureau of Internal Revenue. This letter, together with the reply of the Acting Commissioner, is published below.

March 10, 1941.

COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

Sir:

Under the Internal Revenue Code, the normal tax and surtax is imposed on net income. Individuals owning taxable

securities incur regular and necessary expenses in the care and management of these securities. These consist of investment counsel fees, safe deposit box rental, custodian fees, and bookkeeping and accounting fees necessary for the recording and determination of the correct income and the preparation of reports, income tax returns, etc. These expenses are necessarily incurred in connection with the taxable income therefrom and are a direct charge against such income. True net income is the amount remaining after deducting all the foregoing expenses incurred in the production of such taxable income.

The United States Supreme Court in the recent case of Eugene Higgins v. Commissioner of Internal Revenue held that expenses of the foregoing character were not deductible to an investor.

Since the enactment of the Revenue Act of 1913 the Treasury Department has consistently allowed as deductions from gross income all the ordinary and necessary expenses paid or incurred during the taxable year with respect to the management, protection, and conservation of properties producing taxable income (I.T. 2751, XIII-1, C.B. 43). Recognizing the soundness of this rule, the New York State legislature in 1929 expressly provided for the allowance of expenses incurred in the production of taxable income.

In the interests of sound administration of the income tax law, the Committee on Federal Taxation of the New York State Society of Certified Public Accountants, respectfully requests that expenses hitherto allowed or allowable as deductions pursuant to published Treasury rulings and equitable established administrative policy be continued and that any such deductions claimed in returns for years prior to the time of the Supreme Court decision in the Higgins case, be allowed to remain undisturbed. This Committee is aware of the revocation of I.T. 2751 by I.R. 3452, I.R.B. 1941-8, 4 but believes that the Higgins decision does not necessarily require a retroactive change of the Bureau policy set forth in I.T. 2751. Under Section 3791 (b) of the Internal Revenue Code, the Commissioner is authorized to revoke any ruling without retroactive effect. The position taken by the Bureau in I.T. 2751 reflected an equitable approach to the question of expenses incurred by investors. It has been a well-settled principle in the administration of the federal tax laws to permit deductions of expenses directly related to the production of taxable income and the Bureau's policy of allowing investment counsel fees, custodian fees, bookkeeping and accounting fees to the extent that these fees are related to the production of taxable income should be continued in the interests of fairness for taxable years prior to 1941 when the Higgins case was decided. There are precedents for such administrative action. For example, I.T. 3438 (1940-53-10542) permits the exclusion from gross income of bad debt recoveries if the bad debts were deducted (and did not result in a reduction of federal income tax liability) during the period that G.C.M. 20854 was in effect. This relief was granted as a matter of good faith and was designed to mitigate the effect of the revocation of previous rulings.

This Committee in due course will make specific recommendations to the Joint Committee on Internal Revenue Taxation for the enactment in the income tax law of a provision for the allowance of all necessary expenses incurred in the production of taxable income.

Yours very truly,

Committee on Federal Taxation
of the New York State Society
of Certified Public Accountants
By Nicholas Salvatore
Chairman.

Treasury Department
Washington

March 24, 1941.

Committee on Federal Taxation of the
New York State Society of Certified
Public Accountants,
15 East 41st Street,
New York, New York.

Attention: Mr. Nicholas Salvatore,
Chairman.

Sirs:

Further reference is made to your letter of March 10, 1941, regarding the decision of the United States Supreme Court in Eugene Higgins v. Commissioner of Internal Revenue, No. 253, decided on February 3, 1941, in which it was held that an individual with extensive investments in securities is not entitled to a deduction for expenditures attributable to the handling of securities as an ordinary and necessary expense, paid in carrying on a trade or business.

You state that individuals who own taxable securities incur regular and necessary expenses in connection therewith, consisting of investment counsel fees, safe deposit box rental, custodian fees, etc., which are a direct charge against the income produced, and that the amount remaining after deducting these expenses is the true net income subject to Federal income tax under the Internal Revenue Code. You point out that it has been

the established policy of the Bureau to allow these deductions as set forth in I.T. 2751, C.B. XIII-1, 43 (1934) and that the New York State Legislature in 1929, recognizing the soundness of this ruling, provided for the allowance of expenses incurred in the production of taxable income. It is stated that you are aware of the revocation of I.T. 2751, Supra, by I.T. 3452, I.R.B. 1941-8, 4, but that, in your opinion, the Higgins decision does not necessarily require a retroactive change in the Bureau's policy regarding the matter.

You direct attention to section 3791(b) of the Internal Revenue Code, which provides that the Secretary, or the Commissioner, with the approval of the Secretary, may prescribe the extent, if any, to which any ruling, regulation, or Treasury decision, relating to the Internal Revenue laws, shall be applied without retroactive effect. You contend that there are ample precedents for such administrative action.

The question of the revocation of I.T. 2751, supra, was given careful consideration by the Bureau. It was felt that the Bureau was compelled to revoke the ruling in view of the decision of the court in the Higgins case. For your information, however, the effect of the revocation will not be made applicable to closed cases.

Respectfully

T. C. Mooney
Acting Commissioner.

Securities and Exchange Commission

Independence of Accountants

On March 14, 1941, the S. E. C. issued Accounting Series Release No. 22, which expresses the opinion of William W. Werntz, Chief Accountant for the Commission, regarding the independence of certifying public accountants who have been indemnified by the company whose statements are certified. The full text of this release is published on page 422 of this issue.

Source of Dividend Payments

Release No. 71 under The Investment Company Act of 1940 (dated February 21, 1941), announces the adoption of two rules with respect to disclosure of the source of dividend payments or distributions made by registered management investment companies. The following definitions are taken from the text of this release:

"Section 19 of the Investment Company Act makes it unlawful for any registered investment company to pay any dividend, or to make any distribution in the nature of a dividend payment, wholly or partly from any source other than (1) such company's accumulated undistributed net income, determined in accordance with good accounting practice and not including profits or losses realized from the sale of securities or other properties, or (2) such company's net income so determined for the current or preceding fiscal year, unless such payment is accompanied by a written statement adequately disclosing the source or sources of such payment. The Commission is empowered under Section 19 to prescribe the form of such written statement.

"Rule N-19-1 outlines in some detail the information which must be included in written statements made by management companies pursuant to Section 19. An important feature of the rule is the extent to which it requires explicit and affirmative disclosure whenever a dividend is being paid from a capital source. Another important provision is a requirement that whenever dividends are stated to be paid out of profits from the sale of securities or other properties, the investor must be advised of the extent of any net depreciation of the company's portfolio.

"Rule N-19-2 relates only to dividends paid or declared during the year 1941. It is similar in principle to Rule N-19-1 but requires only a general designation of certain surplus or capital sources, except to the extent that such sources are already segre-

gated in the company's ledger accounts. The purpose of this rule is to give the companies adequate time for reviewing their accounts retroactively in order to meet the standards of Rule N-19-1. The rules become effective March 1, 1941."

Annual Report

The Sixth Annual Report of the Securities and Exchange Commission has just been published, covering activities of the Commission for the fiscal year ended June 30, 1940. The attention of accountants is called to the section on Page 164 of this report entitled "Activities of the Commission in the Field of Accounting and Auditing", which describes cases of an accounting nature which came before the S.E.C. in its administration of the various securities acts. The full report can be purchased for 35 cents from the Government Printing Office, Washington, D. C.

Accountants and Defense

The National Resources Planning Board is preparing a national roster of scientific and specialized personnel to assist in building our defense program, and it is intended to include members of the accounting profession therein. The American Institute of Accountants is assisting in the drafting of a detailed questionnaire, which will probably be sent by the government to accountants within a short time.

Auditing Procedure

Bulletins No. 1 through 7 of the series of statements on auditing procedure recently inaugurated by the American Institute of Accountants have now been published. These are available at the office of the Institute, 13 East 41st Street, New York City, price 10 cents each.

No. 1—Extensions of Auditing Procedure.

No. 2—The Auditor's Opinion on the Basis of a Restricted Examination.

No. 3—Inventories and Receivables of Department Stores, Installment Houses, Chain Stores, and Other Retailers.

No. 4—Clients' Written Representations Regarding Inventories, Liabilities and Other Matters.

No. 5—The Revised S.E.C. Rule of Accountants' Certificates*.

No. 6—The Revised S.E.C. Rule of Accountants' Certificates (Continued).

No. 7—Contingent Liability under Policies with Mutual Insurance Companies.

* Discussed in THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT for March, 1941, page 342.

ELECTIONS

THE following is a list of applicants admitted to membership and associate membership in the Society and also associate members advanced to membership at the meeting of the Board of Directors held on March 17, 1941:

Membership

Forer, Louis, 137 Centre Street,
With Thomas E. Dewey, District Attorney, New York County.
Glick, Maurice E., 190 West 135th Street.
Gorsky, Samuel C., 135 Broadway,
Of Smith & Gorsky.
Gray, Edward, 42 Broadway,
Of Gray, Scheiber & Company.
Jervis, Sidney, Knoxville, Tenn.,
With Tennessee Valley Authority.
Knowlan, John Joseph, 50 Pine Street.
Krengel, David, 1501 Broadway,
With Harry Berman.
Levine, Aaron, 521 Fifth Avenue.
Lynch, James Hugh, 67 Broad Street,
With Haskins & Sells.
Mass, Murray L., 16 Court Street, Brooklyn.
Micchelli, Louis Albert, 60 Park Place, Newark, N. J.,
With Puder & Puder.
Orlans, Sidney, 521 Fifth Avenue,
With Homes & Davis.
Paris, James, 38 Madison Street.
Peck, Robert N., 225 Falls Street, Niagara Falls,
With Power City Trust Company.
Pike, Seymour, 52 William Street,
Of Zirkle, Breden & Co.
Pruzansky, E. Meyer, 1450 Broadway.
Reminick, Philip S., 11 W. 42nd Street.
Schorr, Louis R., 1 Cedar Street,
With Arthur Young & Company.
Seghers, Paul Dotrenge, 120 Broadway,
With Barrow, Wade, Guthrie & Co.
Shannon, George Frederick, 70 Pine Street,
With Peat, Marwick, Mitchell & Co.
Villarosa, Philip J., 120 West 42nd Street.
Weinberg, Seymour, 342 Madison Avenue,
Of Seymour Weinberg & Co.
Williams, John H., 150 Nassau Street,
With George B. Buck.

Associate Membership

Barry, Fernando Leroy, 1 Exchange Place, Jersey City, N. J.
With Atlas Corporation.
Botnick, Israel D., 321 West 44th Street,
With Warner Bros. Pictures, Inc.
Feldman, Ernest Rudolph, 120 West 42nd Street,
With Drucker & Osoff.
Haas, Leo, 321 West 44th Street,
With Warner Bros. Pictures, Inc.
Haker, John Bentley, State Office Bldg., Albany,
With New York State Dept. of Audit & Control, Bureau of Field Audit.
Janelli, Roger A., 1079 Lexington Avenue,
Of Acampora and Janelli.
Kandt, Robert W., 67 Wall Street,
With Arthur Andersen & Co.
Kelly, John Thomas, 56 Pine Street,
With Price, Waterhouse & Co.
Kelly, Michael F., 56 Pine Street,
With Price, Waterhouse & Co.
Korda, Sophie V., 19 West Mohawk Street, Buffalo,
With Y. W. C. A.
Leeder, Michael, 245 Fifth Avenue.
Nauer, Henry J., 80 Centre Street,
With New York State Banking Department.
Pinkul, Lili M., 225 Broadway,
With Pace Institute.
Rosenberg, Sidney G., 80 Centre Street,
With New York State Banking Department.
Sweeney, J. Clement, Lafayette Bldg., Washington, D. C.,
With Reconstruction Finance Corporation.
Taylor, William Fred, Swetland Bldg., Cleveland, Ohio,
With Brubaker, Fisher & Taylor.
Werner, Helmut Otto, 1 Cedar Street,
With Arthur Young & Company.
Williams, Joseph Owen Ivor, 56 Pine Street,
With Price, Waterhouse & Co.

Advancement from Associate Membership to Membership

Barrett, Charles F., 90 Broad Street,
With Lybrand, Ross Bros. & Montgomery.
Berger, Robert B., 342 Madison Avenue.
Bezuyen, Nicholas, 58 Pine Street,
With Discount Corporation of New York.
Blend, John W., Jr., 70 Pine Street,
With Bergen & Willvonseder.

Forsyth, John F., Jr., 40 Rector Street,
With West, Flint & Co.
Goldman, Solomon, 125 Park Avenue,
With S. D. Leidesdorf & Co.
Grabel, Samuel Jay, 450 Seventh Avenue,
With United Audit Co.
Margolis, Julian W., 125 Park Avenue,
With S. D. Leidesdorf & Co.
Pabrey, Wm. J., 30 Rockefeller Plaza,
With Standard Oil Company of New Jersey.
Perrin, Mitchell, 276 Fifth Avenue,
With Aaron M. Kass.
Pickup, Dana Roland, 1720 Rand Bldg., Buffalo,
With Price, Waterhouse & Co.
Ritz, Allen C., 717 City Bank Bldg., Syracuse,
With Stover, Butler, Murphy & Newman.
Roche, James Michael, 80 Maiden Lane,
With Touche, Niven & Co.
Rosen, Irving, 125 Park Avenue,
With S. D. Leidesdorf & Co.
Rubenstein, Jesse, 125 Park Avenue,
With S. D. Leidesdorf & Co.
Schaefer, Marcus J., 100 Fifth Avenue,
Of M. J. Schaefer & Co.
Schlossberg, Alexander, 1450 Broadway,
With Apfel & Gamso.
Schwarz, Hugo, 70 West 40th Street,
With Alexander Dolowitz.
Shewalter, Robert F., 67 Broad Street,
With Haskins & Sells.
Wedemeyer, Arthur W., 56 Pine Street,
With Price, Waterhouse & Co.
Werber, Charles F., Jr., 32 Broadway,
Of Charles F. Werber & Company.
Wilkinson, Theodore Leonard, 15 Broad Street,
With British Purchasing Commission.
Wood, Merwin R., 70 Pine Street,
With Harvey, Fuller & Company.

The number of members in the Society as of April 1, 1941, is as follows:

Members	3,431
Associate Members	426
Total	3,857

Appraisals as Related to Accounting

By Lyle H. Olson

I AM here to speak about properties comprising the fixed assets and their interpolation by appraisals for purposes of accounting. For this purpose I have particularly in mind tangible assets such as the production facilities, or the tools of industry, which constitute much of our National wealth and produce the bulk of our National income.

At the present time, our productive facilities are straining and throbbing to meet the imperative demands of preparedness and war, as well as the ordinary living requirements of our population. These production facilities are now being intensively surveyed to determine the capacity: in use, that available in idle or partially active plants, and the additional capacity necessary to meet the requirements of both war and peace.

Our National income is now about 75 billions per annum. In addition, there is the budget over $30,000,000,000 for National Defense Program. The production of our manufacturing plants is 30 billions per annum (about the same for 1929 and 1940) as measured by the cost or value added by manufacturing to the products produced. The proposed 30 billion expenditures for defense places a tremendous load upon the tools of production—land, buildings, equipment, man-power and investments — and will involve special problems of records, authorizations and controls for the required Certificates and Contracts, Financing and Cost Systems.

These special accounting and appraisal requirements, however, can be referred to here only incidentally, and I will therefore primarily discuss only the normal relationship of fixed assets to the required records of the investment and operation, for use of management, stockholders, investors, and the Government.

Appraising and the Appraiser

In modern management technique, the inspection, recording, and analyzing of property facts come within the scope of appraisal services. There are also requirements, not to be discussed here, for appraisals that are not closely related to accounting. At present, we are only to consider those services of the appraiser that may be related to accounting. As a result of these services the plants and other facilities are translated through appraisals into records or reports which are available to accountants for such applications as they may make of them, either for adjusting or supplementing the accounting records. We must have both appraisal records and accounting records—and they should be closely related and harmonized in terminology and philosophy.

Before we take up the practical problems of appraising and its relation to accounting, it might be well to dispose of some academic questions as to what the appraiser purports to be and what he is prepared to accomplish in his investigations and reports.

Appraising is one of the commonest functions of man. It is the normal product of observation and thought. Recent News records Wendell Willkie's trip to Europe "to appraise the war conditions"; references are also made in the SEC report on McKesson & Robbins, Inc.

Presented at the March 17, 1941 Meeting of the New York State Society of Certified Public Accountants.

such as "a general appraisal of the work" and an "appraisal of this audit" and Professor William A. Paton, in his recent lectures, makes references to "an appraisal of accounting records and procedures". These illustrate the true and correct usage of the term "appraise", that is "to observe and to pass judgment".

The technological or economic use of the term "appraise" is to designate a trained specialized judgment as to property facts usually expressed in terms of money. Appraisal findings may be expressed in terms of dollars of investment, value, depreciation or capacity; or appraisal judgments may be expressed only in terms to designate or describe the existence, condition and utility, without dollar amounts.

Appraising as well as accounting is frequently expressed by very limited definitions, and as an illustration I refer to an edition of Webster's dictionary, defining accounting as "to value" as it also does appraising.(1) I hope for much from your Committee on Definitions in obtaining acceptance of better definitions of both appraising and accounting.

Scope of Appraising

To outline the independent public appraisers' point of view as to the scope of his services and the "to do or not to do" limitations, I may well quote from the appraisers' text book on Basic Standards,(2) certain of its specifications as follows:

1—Appraisal

> As considered herein an "appraisal" means the process of systematic, analytic determination, and the recording and analyzing of property facts, rights, investments, and values, based primarily on a personal inspection and inventory of the property.

2—Appraisal Service

> The term "appraisal service" applies comprehensively to the act of investigating, inventorying, analyzing and reporting upon properties, rights, history, condition, costs, depreciation and other property facts, usually but not necessarily with conclusions of value.

Defining an "Independent Public Appraiser" it says:

> The professional qualifications of an appraiser are trained faculties of observation, specialized knowledge of properties, the analytical ability, experience, knowledge, and judicial temperament necessary for the rendering of a well considered supportable and mature judgment of the investment, earning power, value and the economic probabilities affecting the use of property.
>
> An appraiser is a specialist in investigation, inspection, inventory, analysis, and reporting on investment, value, utility, depreciation, maintenance, and other factual information relating to the properties appraised. His findings may be expressed in an opinion of property facts, value, or any element of value. He takes his primary evidence from identification and inspection of the property, and his opinions should be based upon and supported by observed facts, and analytical and mathematical processes. The appraiser should be qualified by his specialized experience in property inspection, analysis, and valuation, although he may also be an en-

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(1) Account: "To value, estimate or hold an opinion", per Webster's Collegiate Dictionary—Fifth Edition—1940.

(2) "Basic Standards of Appraisal Practice and Procedure", issued by the Association of Appraisal Executives.

gineer, geologist, architect, real estate expert, contractor, technician, accountant or economist.

The Independent Public Appraiser places certain limitations upon his professional activities, and as a part of his standards[2] states:

He should not—

Express judgment on wholly speculative value without mathematical records or other logical supporting data, and where these are subject only to approximation of individual opinion.

Express an opinion of value where the expectation is merely a speculative hope, a valuation is merely a business man's guess.

Investigate or express an opinion as to the title to property appraised, or existing liabilities where he is appraising only tangible assets.

Engage in services in other related professional fields such as accounting, engineering, architecture, financing, management or promotion.

and that—

In all instances be independent of any interest directly or indirectly in the property under investigation—or in the results or use of the appraisal or in the contemplated financing.

Any appraisal may be limited to the presentation of certain property facts, such as description, quality, condition, original or historical cost, costs of reproduction, depreciation on certain elements of value, but the report in all cases should state such limitations so clearly as to prevent the report being misleading. Particular responsibility rests upon the appraiser where disadvantageous conditions are not covered by his report.

He should, upon request or in his own interest, be prepared to make unqualified statements as to his disinterested connection with the enterprise, and the experience and qualifications which warrant his expressions of opinion as a part of or a supplement to his report.

The services of the appraiser (to be exercised within the limits of the individual's qualifications) include the reporting upon tangible assets, such as land, buildings, machinery or merchandise inventories, and intangible assets, such as patents and good will or of capital stock. In the appraisal of the value of rights, patents, good will, and capital stock, the appraiser must use wide discretion as to when the existing development and prospects are sufficient to justify him in expressing the professional opinion of an independent public appraiser.

The sum of the value of the assets, less the liabilities does not necessarily represent the "Net Worth" or an enterprise, and much less the value of the capital stock or specific blocks of capital stock. The market price for capital stock ranges from activity traded stocks on the New York Stock Exchange, down through inactive stocks on various Exchanges and on the Curb, and of those of closely held corporations with few and limited transactions. The market prices of stock may not, and usually do not represent the value of an enterprise or the value of specific blocks of stock.

The procedure of the appraiser, the scope of his investigations and the limitations of his findings should be clearly expressed in his reports. The form of the Certificate or Report of the appraiser is the result of study and experience, and in each case is carefully framed by the appraiser and should be carefully considered by the reader, particularly the accountant.

Costs

Accountants, Appraisers, Economists, and Financiers record properties and investments in terms of "cost". Such terms are fundamental in the consideration of utility, worth and value. It is important that "cost" terms be clearly defined, understood and used. For cost terms as applied to fixed assets I suggest:

"Book Costs" are the amounts for costs appearing on the books.

"Original Costs" represent the actual payments made in money or its equivalent, without consideration of the reasonableness of the cost in relation to value or normal prices. "Aboriginal Costs" is a slang term to designate an original cost to a prior owner, as frequently required to represent the cost when first devoted to the public service.

"Normal Cost" is the payment, reasonably made, in relation to the value of the things acquired. The cumulative record of "normal" costs over a period of time is referred to as "Historical Cost".

"Cost of Reproduction" is the normal cost at which identical or equivalent property might be acquired, constructed or equipped. In this respect, however, reproduction costs are no different than normal costs or historical costs, except as to the date as of which these costs are determined. This is clearly expressed in Professor Paton's Harvard address.(3)

"Trended Costs" are the product of applying price ratios to original costs or earlier or later costs of reproduction, to determine reproduction costs of an earlier or later specific date or period of time.

For purpose of definition, each of these costs may be considered to be the product of the same equivalents of material, labor, overhead charges, contractor's profits, professional fees and indirect construction costs such as taxes, insurance, interest, etc. As a practical matter, in appraisal and accounting practice, it is important when comparing one with the other to see that they are comparable in content. Much confusion has resulted from failure to analyze and reveal the difference in the inclusions in the "costs" of different accounting and appraisal reports.

Purpose of Appraisals for Accounting

Now that we have disposed of these academic phases of our subject, we may get down to the consideration of certain specific and practical considerations. The fields of appraising that have most directly to do with accounting are where the appraiser establishes the property facts for the adjustment or supplementing of the accounting amounts for:

(a) Plant Assets, and Reserves, and Operating and Surplus Accounts.

(b) Departmental or Production Center Records for Cost Accounting.

(c) Stockholders' Reports.

(d) Reports to National Stock Exchanges.

(e) Registration Statements for the Securities & Exchange Commission.

(f) Value of Assets and Resulting Net Worth in Relation to Dividend Declarations.

(g) Reorganizations and Mergers.

(h) Liquidations—in Total or Part.

(i) Income Tax Requirements for Invested Capital, Depreciation, Loss in Useful Value, Profit or Loss, or Sale, or Abandonment.

(3) Recent & Prospective Development in Accounting Theory, Harvard Graduate School of Business Administration, Business Research Studies, number 25—page 16.

These different applications require different premises and procedures for the appraisals which it is not desirable or practical to explain or discuss here. The principles involved may be helpfully presented under such simple major divisions of appraisal usage as follows:

Current Values of Assets.

Cost of Assets, by such Divisions as Book, Original, "Aboriginal" and Historical.

Accrued Depreciation as Related to the Depreciation Reserve Accounts.

Depreciation Provisions as Related to Plant and Cost Accounting and to Income Tax Requirements.

Current Values

Accountants, in recent pronouncements, have emphasized earlier opinions that the fixed asset account should be established and maintained on the basis of original cost, except under such exceptional conditions as mergers, consolidations, quasi-reorganizations or drastic permanent changes in price levels.

Theorists among both accountants and appraisers have at various times supported the periodical or continuous reflection of current values upon the accounts. Normal practice has usually confined the application of current values to the accounts at times of such particular events as radical changes in the price level, plant utilization, or product or capacity requirements; and in cases of new financing, quasi-reorganizations, or mergers and consolidations. Also instances are found where on account of absence of supporting records or earlier faulty accounting practices, it appears desirable to bring the fixed asset accounts into balance with current replacement costs and depreciations of the property assets.

Under many of these varying conditions and in cases of mergers, consolidations, financing or sale where several different interests are involved, it is obviously desirable that some common denominator be used to measure the assets. The most practical common denominator is generally found to be the current values. In appraisal parlance current values are measured, analyzed, or expressed in terms of

Cost of Reproduction New
Accrued Depreciation
Sound Value for Use to a Going Concern.

The application of appraised Cost of Reproduction New, and Accrued Depreciation to the accounts in lieu of the book Asset and Depreciation Reserve accounts, adjusts, corrects, or equalizes all of the accounting variables or inequalities resulting from the varying and indeterminable price levels represented by the book costs, methods of acquisition, differing depreciation policies, and unrecorded deductions, additions, and transfers.

The accounting records having once been restated as on a uniform basis in accordance with the existing useful assets, may then be carried forward on the basis of the actual cost of subsequent additions with or without appraisal assistance for the verification of subsequent property changes and depreciation adjustments. Many concerns use appraisers to periodically check the property changes and reconcile these with the amounts on the accounts. In such cases it is usually desirable to maintain a reconciliation of any write-up or write-down from original costs less reserve established at date of the original appraisal.

This is probably the best place to correct some misunderstandings and to challenge some misapplications of of the Cost of Reproduction base of valuation. Every new property involves an investment or cost which, if normal and reasonable, is also a

cost of reproduction. For purpose of analysis and comparison an old property may be computed at a cost of reproduction of like kind of design and materials, or at a cost of reproduction in accordance with a design or materials best required to serve the purpose. In determining the appraised sound values, the difference between the reproduction cost in like kind or in equivalent matrials may be given effect in the cost of reproduction now or in the allowance for obsolescence included in the accrued depreciation or may in part be reflected in each. The method of treatment will vary with the conditions in the specific case. The correct result must be the value for use.

This explanation however, will not do away with the devastating inferences about the cost of reproduction of a flour mill in a desert, or a refrigerator plant in the Arctic, and which may well be made about some of the skyscrapers in Manhattan.

Book, Original or Historical Costs

Appraisers are also called upon to measure the assets in terms of book, original, "aboriginal" or historical costs. This requires an inventory or record by personal inspection of the assets, investigation of the date of their purchase or acquisition, or date when originally put into service. In these cases, the appraiser's knowledge and records of costs may confirm, supplement, or correct a recorded cost as found in the accounts.

There has been a wide variation in price levels during the past fifty years which results in a wide range in the individual cost figures for assets acquired at different times. But experience has shown that there may be a wider range between the assets originally set up and still carried forward in the accounts and the assets found to be in existence and service as of the date of the appraisal.

The appraiser's greatest service may be:

In inventorying the assets actually in existence and service as of a given date.

In allocating the aggregate book costs of mixed assets to the individual items or classes of items.

Verifying or supplementing uncertain recorded costs or omissions by historical costs of assets identified as having no recorded costs.

Determining by investigation, observation, designs, records of manufacturers' serial numbers, and experience, the dates of construction or installation of assets, where data or cost is not a matter of record.

In total, applying or allocating the actual or normal costs to the individual assets found to be in existence and service.

The method of determination, record and application of these cost findings will vary substantially for different uses, such as plant accounting adjustments, determination of invested capital and depreciation base for income tax purposes, and for rate base and "fair value" of public utilities.

Many experiences illustrate the importance, and sometimes surprising results, from reconciliations of the stated book cost of assets with the original cost of those assets in existence and service.

Accrued Depreciation in Relation to Depreciation Reserve

Assets in the accounts and in appraisals may be recorded or measured in terms of original, reproduction or other costs. But against these costs must be recorded the depreciation that results from time and use.

The appraiser usually determines this Accrued Depreciation by inspec-

tion, observation, experience and consideration of utility for the individual assets with consideration of the—

(a) Deterioration—resulting in loss in value in comparison with a new property, from wear and tear, disintegration, use in service, and the influence of the elements.

(b) Functional Causes—resulting in loss in value through factors of obsolescence, overcapacity, inadequacy, changes in the art, or other similar influences that affect the property item itself or its relation with other items comprising a larger property.

(c) Economic Causes—resulting in loss in utility and value from external economic conditions affecting the character or degree of utilization.

The commonly used term "physical depreciation" is not sufficiently descriptive and may be misleading. The definition of "reasonable depreciation" in the Revenue Code is more satisfactory:

> "A reasonable allowance for this exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence".

In measuring accrued depreciation, the obsolescence is an existing physical or economic fact, subject to definite recognition and measurement.

The depreciation sustained has a very definite relation to the utility and remaining useful life of the asset. There quite obviously should be some reasonable relation between the accrued depreciation of the assets and the amount in the Depreciation Reserve accounts. As appraisers, we aim to present the facts and the application is accountants' responsibility.

The reconciliations of the appraisers' Accrued Depreciation with the accounting Depreciation Reserve may involve consideration of many possible variations in the methods of computing the depreciation. The appraisers' Accrued Depreciation as of factor in the measurement of value will reflect the existing conditions of the assets with consideration to replacements, repairs and extended utility. However, the so-called "depreciation" represented by the Reserve account may be the result of amortization by straight line, accelerated rate, reducing balance, sinking fund, or retirement methods.

These methods are available to both the accountant and the appraiser and are applicable for different purposes. They have to do with the reconciliation of the appraisers' depreciation and the accountants' reserve. It is not necessary that the appraisers' depreciation and the accountants' reserve be the same amounts. It is desirable that they have a reasonable relationship and consistency. It may be desirable that this relationship be expressed and explained in financial reports.

The rules and regulations in reference to depreciation (amortization) allowances and deductions for income tax purposes and for public utility regulations may have to be followed by both the appraiser and the accountant. The existence, condition, and remaining life of the assets, however, are basic evidences against which results of amortization methods must be tested.

Current and Prospective Depreciation Requirements

Possibly of most direct financial importance, is the estimating of depreciation charges which find their way into operating statements, profit and loss or surplus accounts and income tax deductions. These methods of estimating such depreciation (or amortization) requirements are not identical with those for determining accrued depreciation.

The method of estimating these allowances ranges from an average rate applied to one or more property accounts, composite rates applied to respective accounts and classes of assets, down to specific rates applied to individual units.

The appraiser has found that the most satisfactory, accurate and permanent basis is to estimate the required provision on the basis of an inspection of the assets and consideration of their condition, utility, and expected remaining life of each asset or limited groups of similar assets. The periodic provision may be determined by dividing the undepreciated balance by the remaining expectancy of useful life in years, or by determining a percentage to be applied to the undepreciated cost, or to the depreciated cost. To properly control the depreciation provision, the estimated remaining life should be reconsidered and revised periodically as the existing utility and remaining expectancies of life change under varying conditions.

Depreciation provisions determined by the use of "over all" estimates applicable to the whole property, by comparisons with like industries or plants or by life tables are susceptible to errors and miscalculations.

A sound policy is to have the depreciation rates or amounts established by personal inspection of the assets and periodically adjusted in accordance with the best judgment as to the utility and remaining expectancy or life of the individual assets. Depreciation charges are an important and controlling factor in the usually narrow margin of income representing profit. The investor and the regulatory authorities are requiring more explicit information in reference to depreciation provisions and policies. Periodical adjustments in the depreciation provisions actually assist the accountant in maintaining proper control and consistency even though the changes in rates or estimated remaining property lives may call for some explanation in his report.

Depreciation rates may be changed to correct prior abnormality by providing future abnormalities, a possible necessity for income tax purposes but of a very doubtful economic expediency. Correct depreciation charges are vital and controlling factors in estimating production costs by cost centers where the difference between the depreciation and other fixed asset charges have an important but variable relation to the direct material and labor costs. For this purpose at least the depreciation charges should be consistent with the economic facts and the actual loss in service life resulting in the production of the product. The most satisfactory control for all purposes is by means of depreciation provisions applied to property units. This method of control is particularly where the depreciation charges are of such prime importance as under the present normal and excess profits taxes taking 50% and up of the profit dollar.

Property Record and Internal Control

Appraisal service may be a part of a system of internal control. The appraiser may set up property records to serve the accountant as a foundation for the accounting records and control for various purposes. The most desirable, economical and serviceable records should provide for recording all the data and information for each property unit such as:

Date of acquisition and installation.

Original, Reproduction or other costs.

Accrued Depreciation on original, reproduction, or other cost basis applicable to the specific case.

Periodical Depreciation provisions.

Estimated useful life and date of anticipated retirement.

Value for Insurance Purposes.

Investment costs and depreciation charges for accounting and Income tax requirements.

The practicability, economy and desirability of such continuous unit item property control have been well established by many large corporations. This unit control may be on the basis of original costs for accounting and for income tax requirements, but may also include reproduction costs to reflect changes in the price levels for management, cost accounting, insurance, and other requirements.

There is no time here to more than suggest the allocation of costs, depreciation and other burden charges resulting from the fixed assets for departmental or production-center cost accounting. Accounting authorities admit some economic desirability for having a uniform current cost level as a basis for the investment and depreciation charges for different departments and production centers. These may have quite a marked influence on the relative cost of different products.

Appraisals and Accounts

The relation of appraisals to accounting may be further illustrated from Professor William A. Paton's lecture delivered at the Harvard Graduate School of Business Administration under the title, "Recent and Prospective Developments in Accounting Theory". The lecture closes with an interesting, informative, and satisfactory discussion on "Costs and Values"—which he opens by saying, ". . . recorded costs may be generally assumed to indicate true economic significance, actual value, at the moment of incurring. With the passing of time, however, the book figures become less dependable measures of effective, current cost, and in periods of sharp and prolonged price movements the shortcomings of the data shown by the accounts may be serious".

This section of the lecture is an excellent description of the accounting philosophy in reference to costs and values and is satisfactory to the appraiser as to the application of appraisal findings to the accounts, with exception of certain statements which follow traditional precedents in accounting literature, I want to challenge a few of these observations or inferences as not being consistent with the best practice or thought of appraisers, by quotation and comment as follows:

Paton: "First, replacement cost of plant is of marked significance only in the case of standard, up-to-date facilities, which will presumably be replaced substantially in kind. Neither the original cost nor the replacement cost of facilities of an obsolescent character are potent factors in the economic process. . . . This is a point of which professional appraisers are notoriously neglectful".

Appraiser: No one knows better than the appraiser the relation between up-to-date efficient and old, obsolete facilities and the importance of reflecting this in value determination. The replacement cost may be determined on the basis of comparable, up-to-date facilities capable of rendering an equivalent service or the loss may be provided for in the accrued depreciation in accordance with the conditions of the specific problem. Value is not ascertained without giving full consideration to obsolescence in replacement costs.

Paton: "It (recording an appraisal as a very special event under exceptional conditions) does not lend encouragement to schemes which contemplate continuous revaluation and periodic adjustments

of costs and earnings to take into account the movement of either prices or costs of plant".

Appraiser: Practically all of the appraisal adjustments in the plant accounts have been in cases of the so-called "special event" or quasi-reorganization class. There are occasional instances of continuous revaluations and periodic adjustments in the accounts in compliance with the movement of general prices. This procedure has interesting economic results advocated by a few accountants and appraisers. It has had little practical application. The common practice is to restate the accounts as a "special event" as the equivalent of costs and thereafter to carry the assets forward on the basis of subsequent costs.

Professor Paton goes as far in the application of changing values in the accounts and for cost reckonings as the appraiser would recommend.

Paton: "The main alternative is to treat the results of valuation as useful supplementary data and at the same time preserve the frame work of income accounting on the recorded cost basis".

Appraiser: The appraiser has no particular brief or argument in reference to setting appraisal up in the accounts or in reporting the appraisal findings in footnotes and comments, or in an entirely separate report in the financial statement. This depends, in part, upon the character of the appraisal findings. When the accounts are adjusted to conform to the property facts and costs, it may be preferable to have the economic facts and valuations as a separate report.

It is important that the accounting findings and the appraisal findings be harmoniously and understandingly related. Any differences in the amounts should be reconciled and explained, that each statement may be more informative. Greater responsibilities should probably be placed upon the accountant and the appraiser for such reconciliation.

Paton: ". . . the claim that depreciation charges should be based on replacement costs in order to . . . recover replacement costs in case of retirement" (is challenged).

Appraiser: The challenge against an assumed position is correct. The economic justification of depreciation on the basis of replacement cost in operating charges is only that it represents a loss in current values of the assets consumed in production and therefore is properly charged as part of the cost of current production and properly provided for in the price of goods to be sold at current market prices.

Paton: "In most cases, the depreciation charge is relatively a small slice of the operating cost, hence modern changes in this cost usually do not exert a large influence on the total". (The example is given showing 25% change in cost where the amount of depreciation was 10% of the grand cost.)

Appraiser: The illustration tends to evade the problem and is misleading as to the vital importance of variations in depreciation charges in relation to the cost of manufacture (exclusive of raw materials), on profits and on dividends was more specifically illustrated by Hoxsey in an address before the American Institute of Accountants, at Colorado Springs, Colorado.

National Defense Program

The carrying out of the National Defense Program is adding additional importance to the accurate itemization and allocation of the detailed asset records and their depreciation maintenance and other fixed charges, in connection with the property surveys, applications for certificates, preparing contracts and estimating cost of products separately under in-

dividual Defense contracts, foreign contracts and other commercial production.

Preparation is the best Defense. Detailed property records, analysis of amortization, depreciation and fixed charges and the maintenance of supportable cost systems is necessary as protection and defense. All contractors with the Government must realize the expectancy at some time of Government contracts being altered and cancelled, and, the importance of accurate property and cost records to prove the losses incurred and the damages to be recovered. Detailed property records are necessary to maintain and adjust the records for assets acquired prior, and subsequent to, June 10, 1940, that are subject to amortization and depreciation, and those used intermittently on different Defense contracts for foreign contracts and regular commercial production.

The defense contract provisions for leasing and purchase of plants, upon the close of the Defense period, adds to the importance of laying the foundation of detailed property records and the determination of the depreciation and amortization provisions that will have a bearing upon the determination of the purchase prices, and assist in the determination of values at the time of final adjustments.

The Appraiser and the Accountant

Since the appraiser does not serve in the capacity of an accountant, he does not attempt to regulate the account or to control the accountant's presentation. The appraiser, however, does aim to determine the property facts in accord with his experience, through inspection of the assets, study of the economic influences, and set up the facts in terms of such cost and depreciation categories as may be desired by the accountant, or in accordance with the procedure and regulations governing the application of his findings, for the particular purposes required.

When these property facts are presented, it is the responsibility of the accountant to apply them to the accounts. The first fact for consideration is whether the appraisal findings indicate or support the desirability for the adjustment of the account to correct prior accounting in reference to the inclusion or omission of assets, or over or under estimates in depreciation allowances. Appraisals made on the basis of original or normal historical cost, with depreciation in accordance with the principles applied to the accounts, form a definite check upon the correctness of the asset and reserve accounts, and the depreciation (amortization) provisions. When the appraiser reports on reproduction cost and current values, his findings may well constitute a separate statement, to show the relationship between the historical property records and the values reflected by current market conditions.

It is, therefore, important that the reason for the differences in the accounting and the appraisal statements be known and explained. The adjustments in the accounts or the relationship between the amounts may be clearly understood in considering their relationship and the application. These differences, as suggested in preceding paragraphs, may be under one or more of the following classifications, representing differences between:

(a) The assets carried forward and still recorded in the accounts and those found by inspection to be in current useful service.

(b) Depreciation reserve, as accumulated in the accounts, and the accrued depreciation existing in the depreciable assets.

(c) Book costs as stated in the accounts for the assets and the sum of the original or the normal historical cost, for the respec-

tive assets, found by inspection to be in existence and service.

(d) The book or original cost adjusted to apply to the assets in existence and service and the reproduction cost, for the same assets, corresponding changes in depreciation, which should represent the only "writeups" or "writedowns".

It is desirable that the differences between the accounting and the appraisal amounts be analyzed and allocated in accordance with these divisions, in judging as to the application of the appraisal to adjustments of the accounts. The first representing differences in—assets—depreciation reserve or accrued depreciation—book cost and original cost—will ordinarily be recognized as applicable to adjustments of the accounts. The difference between the original cost, as adjusted, and the reproduction cost, and the corresponding differences in depreciation, correctly represent the only appreciation or diminution of current values from adjusted "book values".

The proper relationship and application of appraising to accounting requires a closer cooperation and better mutual understanding between the accountant and the appraiser, in that their cost definitions and procedures and depreciation and amortization methods be harmonized or reconciled, in order that their respective findings may be understood and reconciled.

Where accounting and appraisal statements are used jointly, or separately in the same report, the accountants and the appraisers should be permitted or required to reconcile their findings and, explain, in general terms, the reasons for the adjustment of or the differences in the respective amounts.

Current annual reports show an increasing trend to reflect appraisal findings as supplementary information to the accounting statements in stockholders' reports and financial statements. The required adjustment for income tax purposes contribute to this.

There are important economic and financial reasons to urge a more general reconciliation of the fixed asset accounts, in balance sheets and operating statements with the facts as evidenced by the existing plants and as revealed by appraisal reports.

Accounting Machinery

THE following addresses were presented at a special technical meeting on the evening of October 23, 1940, at the Engineering Auditorium, New York City, under the direction of the Technical Committee on Accounting Machinery. Mr. Lucius H. Coleman, presided in the absence of Mr. Lewis Gluick, Chairman.

The Application of Accounting Machines to the Posting of Accounts Receivable

By DENTON McKANE, C.P.A.

I have been asked to discuss the application of accounting machines to the posting of accounts receivable. Because of the time limitation I shall confine my remarks to accounting machines other than punched card or tabulating equipment.

Posting accounts receivable is the most common accounting machine application. This is probably due to the fact that it is usually the most voluminous job to handle, entailing as it does in many cases the posting of thousands of items to thousands of accounts. The department store field provides numerous instances of such posting volume.

It might be helpful to approach this subject from the angles of why, when and how. In other words, let us discuss the reasons why accounting machines are employed to post accounts receivable, then, when they are employed and, finally, the manner in which they are employed.

First, as to the "why of the thing". The real reason for employing accounting machines, in practically every case, is the economy afforded by their use. All other reasons are minor by comparison. It is the elimination of the manual and mental labor involved in posting and computing accounts, in preparing customers' statements, in making sales journals and distributions, cash receipts journals, and in preparing trial balances that counts. The control over accuracy and the posting speed inherent in a good machine installation both contribute to make the operation an economical one. The elimination of month-end peak loads is also a factor. Neat and legible appearance of work, together with ease of operation, are additional reasons for the use of machines. Another reason is the elimination of unintentional errors such as mistakes in addition or subtraction, transpositions of figures, posting debits as credits and vice versa.

It might be well at this point to state that the intentional "error" which is, of course, no error at all but a deliberate attempt to defraud, cannot be detected through the use of mechanical equipment alone. As is true in manually posted systems, reliance must be placed on internal check and periodic audit. The primary purpose of accounting machine equipment, in so far as accounts receivable are concerned, is to provide a more economical means of posting the accounts and preparing customer's statements, sales and cash journals and periodic trial balances.

Now, as to the "when" of the thing. By this I mean, when can accounting machines be advantageously employed on accounts receiv-

able. The answer obviously is: when there is sufficient posting volume. However, this is not a complete answer, because while there may not be sufficient accounts receivable posting volume in a given case to keep one machine busy each day, there may be sufficient aggregate volume if the machine is also applied to the posting of accounts payable, general ledger, employee's earnings records, stock records, etc. In other words, it is the aggregate posting volume involved in all jobs for which the machine may be used that should be considered.

This brings up another important point, which is that the machine must be versatile if more than one job is to be accomplished with it. By versatile I mean capable of handling more than one job without the operator having to make more than one or two simple and rapid adjustments, such as removing a control plate from the carriage and substituting another, a matter of a few seconds time. Obviously no machine is versatile or flexible if the operator cannot make the necessary adjustments.

For those not too familiar with machine accounting, some figures showing accounts receivable posting production attainable on one machine during one working day may be of interest. In one large West Coast department store, 2,104 postings were recently made in one day of 6⅔ working hours. This is at the rate of about 316 per hour, or 5.26 per minute. By postings I mean sales tickets, merchandise return tickets, etc., each ticket averaging 1.65 items, each item being entered separately. The job in this case consisted of posting to a collated statement and ledger sheet and proving the accuracy of the postings—the so-called "unit plan" of posting. Another department store located in the Mid-West, using a dual plan of posting (preparing statements in one operation and posting ledger sheets in another) has reported that the peak annual production of its best posting operator was approximately 3,300 per day and that the peak annual production of its best biller was approximately 1,890 per day.

So much for the question as to when to employ accounting machines.

Now we come to the "how" of the thing.—How to use accounting machines in posting accounts receivable. The "how" depends on several factors. First, you must decide on what shape the accounts receivable job is to take. Many variations are possible. For example, a statement and ledger sheet can be collated with each other and prepared and posted in one operation, or a statement and ledger sheet can be prepared and posted side by side, each being an original; or a ledger sheet may be omitted and the statement prepared in duplicate, the duplicate copy being retained in place of the ledger sheet, or an invoice, statement and ledger sheet may be collated together and prepared and posted in one operation.

In addition, it may be desirable to prepare a sales journal with a columnar distribution, or a cash receipts journal, as part of the operation, and as a second, third or fourth part of the combination; or it may be desirable to include a continuous age analysis in the posting job so that the statement will show details as to the ages of the items contained in the balance or, instead of a sales journal or cash receipts journal, it may be desirable to include only a proof or tally tape in the combination.

In these variations there are some things that are common to all. For example we are, through "shingling" or "overlapping", preparing several different forms in one writing—statement with ledger sheet or invoice with statement and ledger sheet or state-

ment and ledger sheet with sales or cash journal, etc. Furthermore, in each case we are entering or picking up the last account balance, adding to it and/or subtracting from it a debit or credit, and obtaining a new account balance, which the machine calculates. We are also entering or picking up for a second time the last account balance for the purpose of proving the accuracy of the first pick-up of this balance. The machine usually compares the two old balance pick-ups and if they are in agreement makes it known to the operator by a signal, a locking device or some other means.

Having decided on the shape that the job is to take, attention must be directed to form handling features, degrees of automatism inherent in the machine, proof method to be employed, and the necessity for a writing keyboard or descriptive type of machine.

The machine best suited to a particular accounts receivable job is the one that can accomplish the job in the least possible time with the least possible effort. In other words, it is results alone that count.

In many accounts receivable jobs, form handling alone consumes half or more of all of the time required to make one complete posting. By "form handling" is meant getting the forms from the tray or ledger into the machine in proper collation and alignment with each other, and then removing them and replacing them in the tray or ledger. Therefore, form handling is a very important part of the posting operation and extreme care should be exercised in selecting equipment that permits of easy and rapid form insertion.

The degree of automatism inherent in the machine should be considered. For example, it is claimed by some that if a balance or total is printed by a machine after an operator has depressed only one or two keys, the printing operation is automatic. This is not so. An automatic printing of a total or balance is one where the machine functions without any manual operation on the part of the operator. It is one where the total or balance is printed on a form at the time that the proper column or position is reached, without any attention on the part of the operator. However, compared with the time required by some machines for form handling, automatic printing of totals and balances is relatively unimportant.

The proof method involved in the operation should be carefully considered. A good proof method must be part of every accounting machine operation, otherwise complete control over accuracy cannot be obtained. The proof method should provide assurance that the old account balances have been correctly entered, and that the debit or credit items have been correctly posted. A good proof method should tell you whether or not the old balance and debit or credit items have been correctly entered at the time that the individual posting is made. This is known as line proof. It should indicate where the error was made. It should be positive proof in all cases and not apparent proof in some. Since errors will be made from time to time, it should be possible to correct errors in the easiest and quickest possible way at the time of the discovery of the error.

The machine should be equipped with all possible labor saving devices to eliminate needless manual operations. For example, it should be possible to print a date automatically or with no more than one key stroke. Where possible, the carriage should skip or tabulate automatically from column to column, or from writing point to writing point. On the descriptive type of machine you should be able to write the

words "tax" or "cash" in one key stroke.

For the ordinary accounts receivable job at least one crossfooter and one register should be available in the machine, the crossfooter to compute new account balances and the register to accumulate postings. Very often two crossfooters and two registers are employed, one crossfooter to compute the new account balances, the others to prove the accuracy of the old balance pick-ups; one register to accumulate the debits and the other to accumulate credits. The number of crossfooters and registers needed will depend on the requirements of the particular job.

As I said before, in the final analysis it is results that count. It is the posting production attainable rather than the inclusion or exclusion of certain machine features. The best test in judging a machine is to operate it yourself to ascertain the simplicity of operation and then time the operation to determine the machine's production possibilities. So long as the machine is easy to operate and the production is satisfactory, it matters little as to what particular feature or features are on, or incorporated in, the machine.

Now, in conclusion, a word or two about a few of the terms used to describe machine features may be helpful. Consider for a moment the terms "register" and "crossfooter". A crossfooter is used to cross compute a total or balance. It adds or subtracts, and is usually capable of computing a credit or negative balance. A register also adds and sometimes subtracts, and is used in many cases to accumulate amounts to provide column totals. All crossfooters can be employed as registers, but not all registers can be used as crossfooters.

Then, take the terms "sub-total" and "total". A sub-total in machine accounting means an amount that has been printed by the machine from either a crossfooter or a register without clearing the crossfooter or register. The sub-total is still in the machine and additional amounts may be added thereto or subtracted therefrom. A total is an amount printed by the machine at the time it clears a register or crossfooter, and once it is printed no additional amount may be added thereto or subtracted therefrom without manually relisting it. It is the ability of a machine to either print a sub-total or total in the manner described that widens its scope of usefulness and permits it to accomplish many more different jobs.

The terms "front feed carriage" and "rear feed carriage" are not always readily understood. "Front feed carriage" means, of course, a carriage in which the forms are front fed. They are inserted in front of the cylindrical platen and not behind it such as you would do in inserting forms in a typewriter. "Rear feed" means inserting forms behind the cylindrical platen in typewriter fashion.

Machine Accounting for Payrolls

By J. Lewis Simon, C.P.A.

Every major accounting function must have such elements as accuracy or speed, completeness or economy, or all of these characteristics in order to achieve an efficient control of operations.

But often to attain such efficiency, we must ultimately depend on the machine. And to many business men accounting machinery is as baffling a subject as a surrealist painting is to the average art patron.

However, in the payroll application, the subject we are concerned with tonight, the employer is still more baffled because of the added responsibility of complying with Federal and State legislation which makes it mandatory for him to keep prescribed records or be "guilty of a misdemeanor" subject to criminal and civil penalties.

As we know, such legislation as the Federal Social Security Act, the Fair Labor Standards Act, and the Public Contracts Act, supplemented by related laws of the various states, are cases in point.

To comply with such laws properly, especially in the case of those organizations having a large number of employees, the design and creation of these records represents a task worthy of considerable time and study.

It should be noted that in a payroll consisting of 500 employees, a minimum of 1,000 additional entries must be made as a result of comparatively recent legislation.

Inasmuch as there is no ideal payroll system which can be universally applied, it often becomes necessary to choose a machine best suitable for the operation. Numerous types of machines are available: tabulating equipment employing "punched cards;" typewriter type bookkeeping machines with cylindrical or flat writing surfaces or platens; and the adding machine type of bookkeeping machine having no typewriter keyboard. However, in some routines, duplicating machine methods have been successfully adopted.

Bookkeeping machine equipment is desirable and economical on a payroll of substantial size. Tabulating equipment may be most suitable on the very large payroll, particularly when the same equipment can be used for other purposes. On small payrolls a wide carriage typewriter with certain attachments can be made to serve the purpose.

The basic features of the respective laws and the fundamental principles of the records required can be set forth by the consideration of a case substantially free from unusual conditions.

For the purpose of this discussion we can select a manufacturing corporation located in the State of New York employing 600 people, paid on a weekly rate basis, all employees rendering their entire services within the State of New York, and receiving their compensation by check.

In order to determine the information which payroll records of this corporation must provide, it is necessary to review carefully the requirements of the respective laws, as well as the requirements of accounting and administrative control.

To avoid needless repetition I have compiled a composite list of the information needed to comply with present legislation.

These requirements can be enumerated as follows:

1. Name, address, social security number of each employee.
2. Hours worked each work day and each work week.
3. Regular rate of pay and basis upon which wages are paid.
4. Amount of overtime pay, amount of overtime hours, and other remuneration.
5. Notation as to date hired or released.
6. Details of deductions made from employees' earnings.
7. Provision for proper receipts or vouchers for distribution to employees.
8. Individual records of earnings of each employee.
9. The place of employment must be designated.
10. Total hours worked by all employees and total wages paid during the year.

11. The aggregate amount of "contributions" paid to the State for each payroll period, together with the calculation thereof as well as all supporting data.
12. Date of birth if under 18 years of age.

For administrative and accounting purposes other information would be required such as departmental distributions, details of employee deductions, and other data that would vary depending on the information needed.

Once having determined the information required the next step is the actual form of record to be used and the routine to be adopted.

At this point it would perhaps be wise to pause for a moment. Instead of contemplating what the machine can do and how it does it, it may be well for the purposes of contrast to visualize what effort would be required to post by hand the records needed in the example mentioned a few moments ago.

Thus let us assume that in the application referred to where 600 people were employed only one deduction is required, the Social Security Tax of 1%.

The payroll clerk proceeds to record by hand separate entries on the weekly summary payroll sheet, the employee earnings record, the check stub, the check itself, and then a receipt for the employee.

A study made of this method where only numerical information was entered, reveals that 17 manual operations were involved for one employee.

Only the date, check number, gross earnings, social security tax deduction and net pay were recorded, while the name, social security number and clock number of the employee were omitted.

Further, 17 multiplied by 600 employees means 10,200 entries. And this does not take into account the fact that these records must be added by adding machine or otherwise.

In addition, a time study made shows that it takes 12 hours, 36 minutes, to record this information manually.

Now, what is it that the machine does that shows us how laborious and uneconomical such a process is?

The most outstanding impression one receives in the study of this machine process is the speed of its operation. This can best be illustrated by the fact that it need take only two keyboard operations and two motor bar depressions to produce the same result as performed by the manual operator who goes through 17 operations.

It is the automatic performance of the machine and its production of three records at one time which accounts for the difference of 13 entries for each employee. A more complicated example would show an even greater disparity.

The machine can record the numerical information required in our example and include other information such as an extra earnings item, an extra deduction item, and quarterly gross earnings to date, besides preparing the weekly summary sheet, the employee earnings record, a voucher receipt, a check register, and the check itself at the rate of 200 completed records per hour.

For the 600 employees in the example heretofore given, this operation would take less than three hours, which is quite a contrast to the time required when these records are handled manually.

To those who are skeptical I suggest that they bear with me for a few moments and follow the actual machine performance.

We start first by segregating the weekly time cards in proper sequence as to department and clock numbers.

The machine operator inserts the payroll sheet in the bookkeeping machine as in any typewriter. At the same time the employee record is inserted in the machine through a "front feed" or other type of device and registered with the payroll sheet as to proper writing line. Also, the check with the employee's information stub attached is inserted and registered. Thus, three records are prepared simultaneously.

The machine operator, before proceeding to post, compares all related data to see that the order of the information to be posted is not disturbed.

As the machine carriage automatically tabulates while the entry is made, the machine also prints automatically, the date and check number as required. The first physical contact of the operator with the machine occurs when the keyboard numerals are depressed to indicate the amount of gross earnings. The second operation is to depress the motor bar. The third contact is established when the 1% Social Security Tax deduction is recorded, and the fourth operation is created when the motor bar is immediately depressed.

These four stages conclude the machine operation for the purpose of this application.

From this point, the carriage of the machine moves automatically to the next position and the net earnings are automatically printed on the check stub, employee earnings record and payroll sheet. The machine then prints the net earnings on the check and also records the date and check number without any further effort by the operator. The check stub itself is spot-carboned so that it can record the same information for the pay check register.

While the machine is moving along printing data in the proper columns in automaton-like precision, the operator can utilize the intervening time in placing the next time card and employee earnings record in proper position for the next operation.

In the complete performance of the average payroll operation, more information would be required, such as hours worked, other deductions, and overtime pay. This of course means that many more machine operations would be necessary, but the automatic features would remain the same.

In the comparison of the manual versus the machine operation no weight was given to the time saved in the use of totalizers or registers which accumulate the hours worked, gross earnings, regular and overtime earnings, each deduction, and check amounts.

No mention has also been made of the computation of total earnings to date on the employee's earnings record because of the fact that two more columns would be required for Pick Up and Total to Date which would slow down the machine operation to some extent. However, should this information be required, provision for it can be made. If not, the employee record card can be footed by adding machine or otherwise.

An addressing or addressograph machine is often used for the purpose of printing the name, social security number and clock number of each employee on the various necessary records, although the same data can be typed on a machine with a typewriter keyboard.

The advantages of paying wages by cash or check should be weighed, and the convenience of the employee should be taken into consideration. If payment is made by cash, the machine operation remains the same except that there is substituted for the check, a form of voucher showing the necessary details with a form of receipt attached in lieu of the check. This voucher can be used with a payroll envelope

in such a manner that when folded and inserted under the flap of the envelope, only the receipted form projects. This can be detached and signed by the employee upon delivery of the envelope.

It is often asked what machine features should the accountant look for in order to do away with a good deal of the repetitive work in a manual or semi-manual operation and which will provide the basis for an efficient payroll application.

All accounting machines available today have special features of undoubted merit, but obviously no one machine embodies every conceivable helpful device.

However, the following features are worthy of consideration in any installation:

1. The machine should be capable of accommodating three or more forms in one operation.
2. Visual alignment when inserting forms in the machine should be reduced to a minimum or eliminated, if possible.
3. When deduction columns are not needed, the skipping of the columns should be automatic.
4. Automatic computation and printing of the net earnings.
5. Once the net earnings is computed, the machine should print the net pay amount, date and check number on the pay check, automatically.
6. The check number should advance automatically.
7. In an exceptional case, when the deductions exceed the earnings, the machine should void the check.
8. Automatic accumulation of items in registers and automatic printing of registers.
9. Tray for holding supply of pay checks or envelopes and handling devices that will permit rapid and easy form insertion and removal.
10. A multiplying mechanism may be necessary in some operations.

In conclusion, it should be added that each machine feature should be weighed in the light of other important factors, such as type and number of deductions, and in general the equipment already in the organization should be considered in connection with the selection of new equipment.

SECURITIES AND EXCHANGE COMMISSION

Accounting Series Release No. 22
March 14, 1941

The Securities and Exchange Commission today made public an opinion in its Accounting Series Releases regarding the independence of certifying accountants who have been indemnified, by the company whose statements are certified, against all losses, claims and damages arising out of such certification other than as a result of their willful misstatements or omissions. The opinion, prepared by William W. Werntz, Chief Accountant, follows:

"Inquiry has been made as to whether an accountant who certifies financial statements included in a registration statement or annual report filed with the Commission under the Securities Act of 1933 or the Securities Exchange Act of 1934 may be considered to be independent if he has entered into an indemnity agreement with the registrant. In the particular illustration cited, the Board of Directors of the registrant formally approved the filing of a registration statement with the Commission and agreed to indemnify and save harmless each and every accountant who certified any part of such statement, 'from any and all losses, claims, damages or liabilities arising out of such act or acts to which they or any of them may become subject under the Securities Act of 1933, as amended, or at common law, other than for their willful misstatements or omissions.'

"The Securities Act of 1933 requires statements to be certified by independent accountants and the Securities Exchange Act of 1934 gives the Commission power to require that the certifying accountants be independent. The requirement of independence is incorporated in the several forms promulgated by the Commission and is partially defined in Rule 2-01 (b) of Regulation S-X which reads: 'The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. An accountant will not be considered independent with respect to any person in whom he has any substantial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer or employee.'

"This concept of independence has also been interpreted in Accounting Series Release No. 2① and in several stop-order opinions. *In the Matter of Cornucopia Gold Mines,* 1 S. E. C. 364 (1936), the Commission held that the certification of a balance sheet prepared by an employee of the certifying accountants, who was also serving as the unsalaried but principal financial and accounting officer of the registrant, and who was a shareholder of the registrant, was not a certification by an independent accountant. *In the Matter of Rickard Ramore Gold Mines, Ltd.,* 2 S. E. C. 377 (1937), an accountant was held to be not independent by reason of the fact that he was an employee or partner of another accountant who owned a large block of stock issued to him by the registrant for services in connection with its organization. *In the Matter of American Terminals and Transit Company,* 1 S. E. C. 701 (1936), conscious falsification of the facts by the certifying accountant was held to rebut the presumption of independence arising from an absence of direct interest or employment. *In the Matter of Metropolitan Personal Loan Company,* 2 S. E. C. 803 (1937), it was held that accountants who completely subordinate their judgment to the desires of their client are not independent. *In the Matter of A. Hollander & Son, Inc.,* Securities Exchange Act of 1934, Release No. 2777 (1941) the Commission held that an accountant could not be considered independent when the combined holdings of himself, one of his partners, and their wives in the stock of the registrant had a substantial aggregate market value and constituted over a period of four years from 1½% to 9%

① Accounting Release No. 2 reads in part:

". . . the Commission has taken the position that an accountant cannot be deemed to be independent if he is, or has been during the period under review, an officer or director of the registrant or if he holds an interest in the registrant that is significant with respect to its total capital or his own personal fortune.

"In a recent case involving a firm of public accountants, one member of which owned stock in a corporation contemplating registration, the Commission refused to hold that the firm could be considered independent for the purpose of certifying the financial statements of such corporation and based its refusal upon the fact that the value of such holdings was substantial and constituted more than one per cent of the partner's personal fortune."

of the combined personal fortunes of these persons. It was also held to be evidence of lack of independence, with respect to the registrant, that the accountant had made loans to, and received loans from, the registrant's officers and directors. In the same case, the evidence showed that registrant's president, over a period of years, had used the accountant's name as a false caption for an account on the books of an affiliate not audited by such accountant and that upon learning of these facts the accountant protested and procured a letter of indemnification in connection with such use. It was held that this continued use of the accountant's name, after his protest, and the overriding attitude apparently assumed by the registrant's president in this matter, constituted additional evidence of lack of independence.

"I think the purpose of requiring the certifying accountant to be independent is clear. Independence tends to assure the objective and impartial consideration which is needed for the fair solution of the complex and often controversial matters that arise in the ordinary course of audit work. On the other hand, bias due to the presence of an entangling affiliation or interest, inconsistent with proper professional relations of accountant and client, may cause loss of objectivity and impartiality and tends to cast doubt upon the reliability and fairness of the accountant's opinion and of the financial statements themselves. Lack of independence, moreover, may be established otherwise than solely by proof of misstatements and omissions in the financial statements. As was said in a recent opinion of the Commission:[8]

> "'We cannot, however, accept the theory advanced by counsel for the interveners that lack of independence is established only by the actual coloring or falsification of the financial statements or actual fraud or deceit. To adopt such an interpretation would be to ignore the fact that one of the purposes of requiring a certificate by an independent public accountant is to remove the possibility of impalpable and unprovable biases which an accountant may unconsciously acquire because of his intimate non-professional contacts with his client. The requirement for certification by an independent public accountant is not so much a guarantee against conscious falsification or intentional deception as it is a measure to insure complete objectivity. It is in part to protect the accounting profession from the implication that slight carelessness or the choice of a debatable accounting procedure is the result of bias or lack of independence that this Commission has in its prior decisions adopted objective standards. Viewing our requirements in this light, any inferences of a personal nature that may be directed against specific members of the accounting profession depend on the facts of a particular case and do not flow from the undifferentiated application of uniform objective standards.'

"While Rule 2-01 (b) quoted above designates certain relationships that will be considered to negative independence, it is clear from the opinions cited that other situations and relationships may also so impair the objectivity and impartiality of an accountant as to prevent him from being considered independent for the purpose of certifying statements required to be filed by a particular registrant.

"In the particular case cited the accountant was indemnified and held harmless from all losses and liabilities arising out of his certification, other than those flowing from his own willful misstatements or omissions. When an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability for his own negligent acts, whether of omission or commission, it is my opinion that one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement is removed or greatly weakened.[9] Such condition

[8] *In the Matter of A. Hollander & Son, Inc.*, supra.

[9] It may be noted that Section 152 of the English Companies Act (1929) makes comparable indemnity agreements void:

> "152. Subject as hereinafter provided, any provision, whether contained in the article of a company or in any contract with a company or otherwise, for exempting any director, manager or officer of the company, or any person (whether an officer of the company or not) employed by the company as auditor from, or indemnifying him against, any liability which by virtue of any rule of law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company shall be void."

must frequently induce a departure from the standards of objectivity and impartiality which the concept of independence implies. In such difficult matters, for example, as the determination of the scope of audit necessary, existence of such an agreement may easily lead to the use of less extensive or thorough procedures than would otherwise be followed. In other cases it may result in a failure to appraise with professional acumen the information disclosed by the examination. Consequently, on the basis of the facts set forth in your inquiry, it is my opinion that the accountant cannot be recognized as independent for the purpose of certifying the financial statements of the corporation."

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* * * * *

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